THE WHITE HOUSE

WASHINGTON

May 31, 1985

Natural Resource Subsidy
Telecomm Trade

MEMORANDUM FOR THE ECONOMIC POLICY COUNCIL

FROM: ROGER B. PORTER RBP

SUBJECT: Agenda and Papers for the June 3 Meeting

The agenda and papers for the June 3 meeting of the Economic Policy Council are attached. The meeting is scheduled for 10:00 a.m. in the Roosevelt Room.

The first agenda item is the Natural Resource Subsidy Legislation. The Administration has been requested to testify on this legislation before the Trade Subcommittee of the House Ways and Means Committee on June 6, 1985, and is expected to provide its position on the proposed legislation. A paper, prepared by Ambassador Smith, summarizing the bill's provisions and the alternative Administration responses considered by the Trade Policy Review Group, is attached.

The second agenda item is a discussion of the Administration's position on the Trade and Telecommunications Act of 1985. Senator Danforth has proposed legislation that would provide specific negotiating authority to open foreign telecommunications markets, but would limit Presidential discretion in deciding whether and when to retaliate and in mandating sectoral reciprocity for telecommunications.

The Office of the U.S. Trade Representative,in coordination with the Departments of State, the Treasury, Commerce, Labor, and Agriculture, the Office of Management and Budget, the Council of Economic Advisers, and the Office of Policy Development, has prepared a paper summarizing the provisions in the legislation, outlining the key issues requiring the Council's consideration, and describing the alternative ways the Administration might respond to this legislation. A copy of this paper is attached as is a brief paper containing the principal findings of the 1984 Telecommunications Task Force.

Attachments

THE WHITE HOUSE

WASHINGTON

ECONOMIC POLICY COUNCIL

June 3, 1985

10:00 a.m.

Roosevelt Room

AGENDA

1. Natural Resource Subsidy Legislation
2. Telecommunications Trade Legislation

THE UNITED STATES TRADE REPRESENTATIVE
WASHINGTON
20506

May 31, 1985

MEMORANDUM

TO: THE ECONOMIC POLICY COUNCIL

FROM: Michael B. Smith

SUBJECT: Gibbons Natural Resource Subsidy Bill

At Roger Porter's request, I am sending forward a paper regarding H.R. 2451, the Gibbons Natural Resource Subsidy bill. The paper was discussed by the TPRG on May 17, 1985.

On May 8, 1985, Congressman Sam Gibbons, the Chairman of the Trade Subcommittee of House Ways and Means, introduced H.R. 2451. The bill raises an important political issue. It is almost identical to the natural resource subsidy provision of H.R. 4784, otherwise known as the Gibbons bill, which passed the House of Representatives last year. As a result of strong Administration opposition, the natural resources provision was dropped during the Conference agreement over the Trade and Tariff Act of 1984. While we succeeded in defeating the bill last year, it has considerable support in the House of Representatives.

H.R. 2451 would amend the U.S. countervailing duty law to apply countervailing duties to the pricing practices of certain foreign governments for natural resource inputs, such as oil, natural gas, and lumber. As a result of the OPEC cartel, many oil-producing nations maintain dual-pricing systems for oil and natural gas. These countries export oil and natural gas at the prevailing world market price, but sell these products at much lower prices to domestic users. This has generated complaints by U.S. manufacturers of energy-intensive products, such as gasoline, ammonia, cement, and carbon black, who must pay the world price for oil and natural gas fuel or feedstocks and who fear that they are at a long-term disadvantage vis a vis Saudi Arabian and Mexican producers. The basic idea of the Gibbons bill is to treat the difference between a foreign government's export price (or a "fair market price" if there are no exports) and its internal domestic price as a countervailable subsidy. This would protect U.S producers by preventing foreign producers from selling below U.S. costs of production.

At the TPRG level, all agencies opposed the natural resources bill. Every agency except the Department of Labor recommended that we adopt Option 2 of the discussion paper, i.e. strongly oppose the bill, but indicate that we have initiated an intensive

study of the potential for long-term trade problems in the area of energy-intensive products. The Department of Labor, however, believes that we should combine Options 2 and 4 by offering to work with Congressman Gibbons and the Trade Subcommittee to develop a reasonable compromise version of the bill. The other agencies recognize that offering to work with Congressman Gibbons would help our long-term relations with the Trade Subcommittee, but believe that our conceptual differences with the Subcommittee approach taken in this bill are so great that the gap would be impossible to bridge. These agencies also believe that holding out flexibility could encourage the coalition and help build support for the bill. Accordingly, we must decide whether to adhere to Option 2 or to offer to work with the Trade Subcommittee.

We must also decide on the scope of the inter-agency study. The study is currently focusing on the issue of energy resources. However, in an attempt to win additional support, Congressman Gibbons has amended the bill to provide countervailing duty relief to U.S. lumber producers. Hence, the scope of the study may require some clarification.

CONFIDENTIAL

Discussion Paper - Gibbons Natural Resource Subsidy Bill

Issue: On May 9, 1985, Congressman Sam Gibbons introduced H.R. 2451, a new version of the natural resource subsidy amendment originally contained in the Trade Remedies Reform Act of 1984 or Gibbons bill. The Gibbons bill passed the House of Representatives, but was dropped during the Conference agreement over the Trade and Tariff Act of 1984 as a result of Adminstration opposition. The International Trade Subcommittee of the House Ways and Means Committee has scheduled hearings on the new proposal ("Natural Resources II") for May 14, May 15, and May 30, 1985. The Subcommittee expects the Administration to testify on May 30. Accordingly, we need to develop a position on Natural Resources II. In addition, we need to evaluate the potential for long-term trade problems in the petrochemical/natural resources area. Assuming such problems exist, we need to develop a longer--term strategy for dealing with a set of related issues revolving around natural resources, petrochemicals, Saudi Arabia, Mexican dual-pricing etc.

Recommendation

(1) The Administration should oppose Natural Resources II. The Administration should indicate, however, that we are conducting an intensive study of the broader natural resources/petrochemicals issue.

(2) We should reiterate our opposition to Natural Resources II and push ahead as quickly as possible with the study. At this point, we lack the basic factual analysis necessary to determine whether a long-term natural resources problem exists or, assuming there is a problem, to assess possible long-term strategies.

Background

The natural resource subsidy issue is one of great complexity. At one level, the issue touches on the potential effects of OPEC cartel prices on downstream industries, as oil-producing countries attempt to exploit their oil and hydrocarbon resources by moving into gasoline and refined petrochemicals. At another level, the issue relates to the pricing policies of a number of oil-producing countries, such as Mexico and Saudi Arabia, and the persistent criticism by U.S. industries of Mexico's dual-pricing system for oil and natural gas. Finally, at a political level, a coalition of U.S. ammonia, cement, and carbon black producers has pressed for amendments to the U.S.-countervailing duty law to strike back at what they contend are unfair trade practices. They have allied themselves with independent petroleum refiners and with lumber producers who object to a 1982 decision of the Commerce Department rejecting the imposition of countervailing duties on Canadian softwood lumber.

CLASSIFIED BY Donald M. Phillips

CONFIDENTIAL

The natural resources issue first gained prominence in 1982 and 1983 when the U.S. ammonia, cement, and carbon black industries filed a series of petitions for countervailing duty (CVD) relief against imports from Mexico. The CVD investigations focused on Mexico's dual-pricing system for oil and natural gas. The production of ammonia, cement, and carbon black industries is energy intensive. By law, PEMEX, a government-controlled corporation, has a monopoly over the exploitation of Mexico's hydrocarbon resources. Under the dual-pricing system, Mexico exports oil and natural gas at world market prices, but sells oil and natural gas to domestic users at a much lower, government-regulated price. In 1982, Pemex was exporting natural gas at approximately $4.82 per MMBtu, while selling gas to domestic users at approximately $0.53 per MMBtu. Oil was being exported at the world (OPEC) price while domestic oil products were priced at fraction of world levels.

The lower Mexican domestic price was, however, available to all industrial users of oil or natural gas in Mexico. Under section 771(5) of the Tariff Act of 1930, a countervailable subsidy must be provided or bestowed on a "specific enterprise or industry, or specific group of enterprises or industries." Accordingly, the Commerce Department determined that the benefit was "generally available" and did not constitute a countervailable subsidy. See Carbon Black from Mexico, 48 Fed. Reg. 29564 (June 27, 1983).

Similarly, in 1983, the lumber industry lost a bitterly contested countervailing duty investigation of Canadian softwood lumber. The most important issue in the case was whether stumpage programs of the Canadian and Provincial Governments constituted countervailable subsidies under U.S. law. Under the stumpage programs, the Canadian and Provincial governments grant logging rights on government-owned forest lands at rates much cheaper than those charged in the U.S. Applying section 771(5), the Commerce Department determined that the stumpage programs were not limited by government action to a specific group of industries or and therefore did not represent a countervailable subsidy.

Subsequently, a coalition of ammonia, cement, and carbon black producers began to press for changes in the CVD law to enable them to obtain import relief against imports from Mexico. The coalition found a sympathetic listener in the House International Trade Subcommittee under the leadership of Congressman Gibbons, which was then in the process of drafting the Trade Remedies Reform Act of 1984. The so-called Gibbons bill would have amended the CVD law to reach so-called "natural resource subsidies." It defined a natural resource subsidy as the difference between the government-controlled domestic price for a natural resource and the "export price or fair market value (whichever is appropriate) of the product ..." This difference would be countervailed if (1) the resource is not "freely available" to U.S. producers for purchase for export at the low

CONFIDENTIAL

 CONFIDENTIAL

domestic price and (2) the resource accounts for a "significant portion" of the total cost of manufacture or production. Accordingly, the provision would prevent a country from exporting hydrocarbon derivatives for less than the equivalent export price of the basic raw material or in certain situations, a "fair market value" defined as the price a willing buyer would pay in an arms-length transaction in the absence of government regulation. The lumber industry did not join the coalition because at that time the industry was split between the large companies, like Weyerhauser, who owned timber rights in Canada, and the smaller companies, who did not.

During hearings on the Gibbons bill, the Administration strongly opposed the natural resource subsidy provision. We were joined by U.S. agricultural interests, who feared that countervailing duties on ammonia would drive up fertilizer costs and result in retaliation against U.S. agricultural exports, and by a number of companies who were either importing Mexican ammonia or had invested heavily in overseas facilities that might fall under the sweeping definition of the Gibbons bill. Nevertheless, the bill, including the natural resource subsidy provision, passed the House by a substantial margin (259-95) during consideration of the Trade and Tariff Act of 1984.

During the Conference, however, the Senate conferees held firm against the natural resource subsidy amendment. Accordingly, the provision was dropped and did not become part of the Act. Nevertheless, Ambassador Brock offered to conduct an in-depth study of the natural resources issue. As a result, an inter-agency working group was formed in January to review the issue, determine the extent (if any) of the long-term problem, and explore possible approaches to the situation.

For its part, after failing to win enactment of legislation during the Trade and Tariff Act of 1984, the ammonia, cement, and carbon black coalition cast about for additional support. They linked up with the independent gasoline refiners, who have been experiencing economic difficulties recently and blame their problems on imports. The refiners would like to obtain gasoline quotas, but in the meantime support the natural resource amendment. With the Independent Refiners joining to support Natural Reources II, opposition can be expected from major oil companies with investments abroad, independent petroleum marketers, and gasoline consumers.

The new bill (Natural Resources II) also expands the natural resources subsidy provision in an effort to win the support of Northwestern lumber interests. As revised, the bill retains essentially the same definition of a "natural resources subsidy," i.e. a government dual-pricing scheme that results in the sale of natural resource inputs below "fair market value." In general, the fair market value would be the world market price if the resource can be sold on the world market. To get at Canadian stumpage practices, the bill contains a new provision regarding

CONFIDENTIAL

"removal right subsidies." The new language declares a removal right subsidy to exist if "the right to remove or extract a product (hereinafter in this section referred to the "removal right") is provided or sold by a government or a government regulated or controlled entity within a country and ... the removal right is provided or sold at a domestic price that is lower than the fair market value of that right ..." While the bill contains a complicated definition of the fair market value of a removal right, it basically defines fair market value as the free market price in a country, other than the subsidizing country, with the largest number of arms-length sales of removal rights. Applied to the Canadian lumber situation, the benchmark would be the arms-length price of logging rights in the U.S., since outside of Canada the U.S. has the largest number of sales of timber rights.

Discussion

The Administration has consistently opposed the natural resource subsidy provision. During hearings on the Trade and Tariff Act of 1984, the Administration repeatedly testified in opposition to the natural resources amendment (see Attachment A). We opposed the amendment for the following reasons:

(1) GATT-consistency -- The amendment treats "generally available" natural resource subsidies as countervailable and therefore violates the internationally accepted definition of a countervailable domestic subsidy. There is broad international agreement that "specificity" is the appropriate test of a countervailable domestic subsidy.

(2) Foreign Retaliation -- Assuming the natural resources amendment violates the accepted international rules, it invites foreign retaliation against our exports.

(3) Mirror Legislation -- The U.S. government regulates the price of natural gas and in addition provides a number of resource inputs on a subsidized, government-regulated basis, e.g. Western irrigation water, government electricity projects, the TVA, timber rights, oil leasing, etc. While such commodities may not fit within the bill's definition of a "natural resource subsidy," other governments would not be bound by a self-serving U.S. definition and could use mirror legislation to strike at U.S. resource practices.

(4) U. S. Investment -- Many U.S. oil and petrochemical producers, particularly the multinationals, have invested in joint ventures in Saudi Arabia and other oil-producing nations. To impose countervailing duties on products developed through such investments rises questions about the fairness and consistency of our investment policy. As a practical matter, the natural resources amendment could have the effect of (a) nullifying U.S. investments abroad and (b) discouraging oil-producing countries from entering into

economic relationships with U.S. firms.

(5) Comparative Advantage -- The amendment cuts against comparative advantage by denying foreign firms the ability to exploit their supplies of cheap natural resources. While dual-pricing is a form of market distortion, the fact remains that Mexico has abundant supplies of cheap natural gas. While the industry sometimes argues that Mexico is selling below cost, it is only doing so if one takes Mexico's "opportunity cost" for natural gas. In real terms, Mexico is selling ammonia for significantly more than its out-of pocket cost, even though it arguably could realize an even greater profit by exporting natural gas, instead of ammonia.

(6) Sovereignty -- We have argued that the amendment intrudes on the sovereignty of foreign nations by seeking to dictate domestic natural resource policies and prices.

These criticisms are equally valid today. While the new bill changes the definition of a natural resource subsidy slightly, the core of the natural resource provision remains the same.

To the above criticisms can be added the following. In applying the countervailing duty law, we have drawn the line on countervailable domestic subsidies through the "generally available" standard. To drop the "generally available" test as a bright line distinction would leave us at sea and create significant problems in the administration of the CVD law and with our trading partners.

Moreover, given our probable long-term dependence on Mexico, Saudi Arabia, and the OPEC cartel for energy supplies, we should give some thought before taking the potentially risky step of unilaterally precluding these nations from selling hydrocarbon derivatives in the U.S. market for below U.S. costs of production. This type of action could have an adverse effect on our economic relations and should not be undertaken without detailed study.

Further, there are those who doubt, as a matter of economic theory, that dual-pricing can exist in petroleum product markets over the long term. Under this view, given the competitive nature of the world petroleum market, it is doubtful that dual--pricing in volumes large enough and persistent enough as to do damage to the U.S. market can exist without undermining OPEC crude pricing policies. Those who hold this view would also argue that it is speculative that anticipated new OPEC refining capacity willl have a significant impact on the U.S.

Finally, the new language regarding removal rights merely compounds the problems of the original Gibbons bill. The new language illustrates the difficulties of amending the CVD law to overrule a particular case and to extract an affirmative determination for a particular industry. As a practical matter, the removal rights provision is designed to ensure that the difference

CONFIDENTIAL

between Canadian and U.S. stumpage fees is countervailable. As a result, the bill provides that the benchmark of a removal right subsidy is the free market price in the foreign country with the largest number of comparable removal rights, a definition that conveniently would result in a U.S. benchmark in a lumber CVD case. Nevertheless, it is wholly unclear why the fact that Canada sells timber removal rights for less than comparable rights in the U. S. makes the Canadian sales a subsidy. Certainly, this circumstance would not create a subsidy under any internationally accepted definition. Rather, the aim of the removal rights amendment appears to be wholly protectionist in nature, that is, it seeks to ensure that foreign producers can never undercut U.S. timber prices.

Because the definition of a removal right subsidy has been crafted to fit the situation of a particular U.S. industry, rather than as a neutral and objective criterion, it raises serious practical problems. We would never concede, for example, that if a U.S. firm obtains the right to exploit a government regulated natural resource at less than the price in some foreign country, then that difference necessarily constitutes a countervailable subsidy. The lower price may represent the comparative abundance of that resource within the U.S. As a practical matter, therefore, the amendment raises the possibility of mirror legislation or foreign countervailing duties against U.S. lumber, mining, and oil producers, who benefit from U.S. government removal rights, and presumably seek to obtain such rights at the lowest possible price.

At this point, the Adminstration has essentially four options. We can:

(1) <u>Option 1</u> -- Flatly oppose the natural resource amendment in Congressional testimony on May 30;

(2) <u>Option 2</u> -- Oppose Natural Resources II, but indicate that we are conducting an in-depth study of the natural resource issue to review the nature and extent of the problem.

(3) <u>Option 3</u> -- Stall by seeking to avoid commenting.

(4) <u>Option 4</u> -- Offer to work with Congressman Gibbons and the Subcommittee to refine the proposal.

In evaluating the various options, we need to weigh the following:

(1) The merits of the natural resources provision and the reasons that we opposed it last year;

(2) The possibility of crafting some type of acceptable natural resources provision by working with Congress on the natural resources bill;

CONFIDENTIAL

CONFIDENTIAL

(3) Our ability to offer any alternative approach to the House Subcommittee's proposal to amend the antidumping and countervailing duty laws;

(4) The prospect of adverse legislation being enacted over Administration opposition; and

(5) Our long-term relations with Congressman Gibbons and the House International Trade Subcommittee.

(6) The potential for a long-term trade problem in the natural resources/gasoline/petrochemical area.

Option 1 -- This option would reflect our serious reservations as to the merits of Natural Resources II. It would lay down a marker by demonstrating the Administration's absolute opposition to what we regard as an ill-conceived piece of legislation.

The weakness of this position is that it ignores the potential for a serious long-term trade problem in the natural resources area. As noted above, certain oil-producing countries are beginning to move into downstream products, such as gasoline and petrochemicals. Recently, there was a great deal of speculation in the trade press about the potential impact of Saudi Arabian petrochemical plants coming onstream. The ammonia industry and independent gasoline refiners have experienced serious economic difficulties in the past few years, although the link between the economic harm and imports is unclear. If there is a serious problem, a position of flat Administration opposition could be seen as foolish and insensitive.

Moreover, if the coalition concludes that the Administration is going to ignore the problem, it might decide to push ahead to a confrontation, thereby increasing the potential for problem legislation and compounding our political problems. At present, the coalition is only loosely united; we risk further uniting them by a shared frustration with the Administration approach.

<u>Option 2</u> -- Under this option, we would reiterate our criticisms of the natural resource subsidy provision, but indicate that we are prepared to study the issue and have in fact initiated an inter-agency study.

This option offers the best prospect of balancing the various factors at work here. We have in the past opposed the concept of amending the antidumping and countervailing duty laws to reach natural resource pricing practices. Given our fundamental opposition to the Gibbons concept, we should make our views known at the very outset in an effort to prevent the bill from gathering momentum. We cannot realistically hold out much possibility of compromise over amendments to the AD and CVD laws to remedy foreign natural resource pricing policies. To hold out a possibility of Adminstration support would only create false hopes and encourage

CONFIDENTIAL

CONFIDE...

other industries to join the coalition.

While opposing the bill, we can hold out a degree of flexibility in the form of the Adminstration study. We have very little in the way of empirical data and analysis of the natural resources issue. As noted earlier, the issue touches on a number of complex problems, including the pricing policies of a variety of oil producing countries, the condition and competitiveness of U.S. petrochemical producers and gasoline producers, and the effects of the OPEC cartel on downstream U.S. industries and markets. Until we have reviewed the nature and extent of any problems in this sector, we cannot develop any coherent long-term approach.

The option will not make Congressman Gibbons happy. On the other hand, he and other supporters of the bill are unlikely to be surprised by Administration opposition. A second drawback of this position is that it may not deter the coalition from-attempting to steamroll us, although the risk of confrontation is somewhat less than that of option 1. Nevertheless, while there are drawbacks to Option 2, these drawbacks are difficult to avoid, absent a complete reversal of Administration position. Accordingly, our aim should be to seek to minimize the costs of opposition to the basic concept.

Option 3 -- Under this option, we would stall by seeking to avoid commenting on the bill. We could try to avoid testifying altogether or cite the study as justification for our lack of a position.

The difficulty with this option is that it (1) may encourage the natural resources coalition and (2) is unlikely to satisfy bill's supporters. In view of the history of vigorous Administration opposition, the lack of an Administration position could be seen a foreshadowing an eventual change of position. The coalition and its Congressional supporters could be led to believe that the Administration has some flexibility on Gibbons II. This could help the bill gain momentum.

From the standpoint of placating Congressman Gibbons, our lack of a position is likely to make him just as upset and could be criticized as fumbling with an important issue.

Option 4 -- Finally, we could offer to work with the Subcommittee to refine the proposal to accomodate administration objections. The problem with this approach is that it would be almost impossible to bridge our fundamental conceptual differences over this type of amendment to the AD or CVD laws. In coalition's mind the difference between the price U.S. producers must pay for a natural resource and the government-regulated price foreign producers pay constitutes a subsidy. We disagree. Given this basic divergence, it is difficult to see how we could negotiate a compromise. We could not, for example, split the difference or agree on a special statutory test for CVDs on Mexican ammonia and

CONFIDENTIAL

CONFIDENTIAL

Canadian lumber.

Holding out this type of flexibility could encourage the members of the coalition and help the bill to gain support. Finally, while we could have some short-term gains in our relationship with the bill's supporters, these gains are likely to be dissipated when we eventually fail to reach agreement and formally oppose the bill.

Accordingly, we recommend Option 2.

CONFIDENTIAL

ILLEGIB

Page Denied

Sanitized Copy Approved for Release 2010/05/13 : CIA-RDP87T00759R000100170024-3

either petitioner or respondent; and (h) clarify that where a suspension agreement is intentionally violated, the U.S. Customs Service shall undertake a Customs fraud investigation.

The Administration must oppose the provisions of the bill relating to targeting, natural resource subsidies, and downstream dumping. While we are sympathetic to the concerns behind these proposals, we believe that they are contrary to the international obligations of the United States, represent dangerous international precedents, and pose direct or indirect threats to American exports. The reasons for our opposition are set forth in Appendix A.

A detailed section-by-section analysis of the remaining provisions of the bill is attached at Appendix B.

The Administration supports the concept of an artificial pricing test to replace both the antidumping and countervailing duty laws with respect to countries with non-market economies. We were disappointed that these proposals were dropped from the Subcommittee's bill. We urge their incorporation. In artificial pricing investigations, we believe that an injury test should be provided where required by the international obligations of the United States. A copy of our proposal is attached at Appendix C.

We also attach at Appendix D 44 highly technical, non-controversial changes to the antidumping and countervailing duty laws. These changes are designed to clarify ambiguities, correct mistakes, and improve the administration of the laws.

There is no objection to the presentation of this report to the Congress from the standpoint of the Administration's program.

Very truly yours,

Malcolm Baldrige

Malcolm Baldrige
Secretary of Commerce

William E. Brock
United States Trade Representative

CLG:tjc

Administration's Position on the Danforth Telecommunications Bill

PROBLEM

The Danforth telecommunications trade bill poses fundamental issues for the Administration's conduct of trade policy -- it provides specific negotiating authority to open foreign telecommunications markets, but limits Presidential discretion in deciding whether and when to retaliate and in mandating sectoral reciprocity for telecommunications. The EPC must now decide whether: (1) the Administration wants such new negotiating authority specifically on telecommunications; (2) if it does, in what form; and (3) if it does not, how to frame our opposition in the least confrontational manner. This decision is, to a large extent, a matter of political judgment.

SUMMARY OF THE BILL

The bill's intent is to give the President negotiating leverage to open foreign markets for U.S. telecommunications equipment and services. Specifically, it includes two elements:

First, the bill requires the President to undertake negotiations with countries that have substantial, but partially closed, telecommunications markets to achieve "substantially equivalent competitive opportunities" ("SECO") as compared to those available to foreign suppliers in the U.S. market. To do this, the President is authorized to make concessions affecting U.S. trade in telecommunications and other products, subject to Congressional approval. If no agreement is reached within two years, the President is required to take any of seven retaliatory actions "as necessary to fully achieve" the bill's objectives, including SECO.

Second, the bill requires retaliation by the USTR against those countries which he finds have violated an agreement affecting telecommunications trade. A "violation" for this purpose includes the failure of U.S. telecommunication exports to a particular country to achieve a level "reasonably anticipated" under the trade agreement in light of the competitiveness and export potential of the U.S. industry.

Positive Elements: The bill has several positive elements, the most important of which include:

(1) giving the President new authority to grant trade concessions in telecommunications and other areas, subject to Congressional approval on a fast-track basis;

(2) giving the President authority to compensate countries against whom he retaliates as may be necessary under the

GATT; and

(3) putting pressure on our trading partners, particularly Japan, to liberalize their telecommunications markets.

Negative Elements: The bill's negative elements include:

(1) requiring the President to seek no less than sectoral reciprocity in his negotiations on telecommunications or retaliate;

(2) effectively making telecommunications trade the President's highest negotiating priority in the sense that it would be the only sector in which he will be authorized to seek liberalization in return for U.S. concessions in **other** areas;

(3) transferring the existing 301 authority to retaliate on telecommunications from the President to the USTR; and

(4) running the risk if we retaliate that other countries would counter-retaliate thereby closing telecommunications markets both here and abroad.

LEGISLATIVE ASSESSMENT

This bill reflects growing discontent in the Senate and in the business community over the Administration's trade policy as it relates to telecommunications. Last year, when Senator Danforth introduced similar legislation, his colleagues and the business community showed little interest. This year, the bill has five co-sponsors (Senators Bentsen, Heinz, Inouye, Lautenberg, and Wilson). And, the industry (AT&T, IBM, GTE, and the Chamber of Commerce) now support the need for special trade legislation on telecommunications. Labor, as represented by the IBEW, feels the bill isn't tough enough. This discontent has arisen because the Administration has not retaliated against any nation, particularly Japan, for failure to open its telecommunications market. Hence, the present bill is intended to limit the President's existing discretion to decide whether and when to retaliate. If negotiations fail to open markets within two years, retaliation is mandatory.

The Administration has avoided taking a formal position on Senator Danforth's telecommunications trade bills. Last September we were asked to testify, but at the last minute declined to appear because of internal differences on the bill. These differences remain unresolved in consideration of the present bill so the Administration declined to testify on it at a May 3 hearing. An Administration position should now be conveyed to Senator Danforth as soon as possible and no later than the mark-up which is likely to occur immediately after the Memorial Day recess.

If our trade balance in telecommunications continues to deteriorate rapidly (as we expect it to), some Congressional action this session can be expected. More troublesome legislation has already been introduced. The Chafee bill, for example, prohibits imports of Japanese telecommunications equipment until the President certifies that Japan is as open as the U.S. market. Opposition to the Danforth bill could give impetus to these other bills.

KEY ISSUES

There are essentially four issues that the EPC must address in deciding what recommendations to make to the President on the Danforth bill.

1st Issue: Does the Administration want additional, sector-specific negotiating authority (i.e., authority to reduce U.S. trade barriers in exchange for market access concessions from other countries solely in telecommunications)?

This is the fundamental, philosophical issue. If as a matter of general trade policy the Administration does not want sector specific negotiating authority, it should oppose the Danforth bill.

The President already has the authority under Section 301 to restrict a country's access to the U.S. telecommunications market as a means for creating negotiating leverage. (Such authority has never been invoked; Ed Spencer of the U.S./Japan Advisory Group has written Secretary Baker urging Section 301 action against Japan as soon as possible.) The Danforth bill enhances Section 301 leverage by giving the President additional authority to restrict access to the U.S. market and by authorizing the President to give concessions on telecommunications and other products.

The agencies disagree about the need for this additional, sector-specific negotiating authority. Some believe that accepting such authority sets a dangerous trade policy precedent in codifying sectoral reciprocity and in allowing Congress to grant negotiating authority on a sectoral basis rather than a general basis. These agencies also believe that the President has adequate existing authority to negotiate and that one-way authority to grant concessions in other sectors would not be particularly useful.

Other agencies believe that we need the additional authority to open telecommunications markets other than Japan. They argue that the only negotiating leverage we currently have is threatening to close the U.S. market unless other countries agree to unilaterally open their markets. This "negative negotiating leverage" alone is of limited utility because many nations (i.e., the

European Community at present) stand to lose little if the U.S. market is closed to them. The Danforth bill improves this situation by giving the President "positive negotiating leverage"; that is, the authority to grant U.S. concessions in a telecommunications trade agreement. This gives the President a clear legislative mandate to negotiate.

<u>2nd Issue</u>: If the Administration wants additional, sector-specific negotiating authority, can it accept some limit on Presidential discretion in deciding whether and when to retaliate as a trading chip with Congress to get the authority?

This is an important issue to Senator Danforth and the business community because they are convinced that the President will **never** retaliate unless he is required to by law. No agency supports the limits currently included in the bill. However, some would accept, rather than mandatory retaliation, the requirement that the President report to the Congress in writing on how he uses all the authorities that would be granted to him in the bill. Other agencies believe that we should not compromise on this issue at all.

<u>3rd Issue</u>: If the Administration wants additional, sector-specific negotiating authority, can it accept required sector reciprocity (i.e., SECO) as the principal negotiating objective as a trading chip with Congress to get the authority?

This issue is not as critical to Senator Danforth and the business community as the second issue is. No agency supports **required** SECO or SECO defined as the mirror image of the U.S. market. SECO in this context would constitute strict sectoral reciprocity and hence would be contrary to the Administration's trade policy. But, the Administration has already accepted SECO as one of many negotiating objectives we should try to achieve. SECO is a major objective in the MOSS negotiations with Japan and was accepted by the Administration as a general negotiating objective in the 1984 trade act.

<u>4th Issue</u>: What would be the impact of the Administration's position on development of the telecommunications market?

If the Administration opposes the Danforth bill, the U.S. business community and our trading partners will infer that we are not serious about opening foreign markets. This will diminish the likelihood of succeeding in our efforts to expand U.S. exports, and the trade deficit in telecommunications will likely continue to increase well beyond $2 billion. On the other hand, if the Administration supports the bill and it is enacted, the President will probably end up retaliating against some nation, probably the European Community, which will likely counter-retaliate. The result will be a more restricted world market in telecommuni-

cations to the detriment of consumer welfare worldwide. Approximately $50 billion in telecommunications equipment was purchased worldwide last year, about 40 percent (i.e., $20 billion) of which was purchased in the United States.

OPTIONS

The Administration essentially has three options.

Option 1: Support the Bill

Under this approach, the EPC would recommend supporting the bill with small technical changes.

Rationale

The President has little negotiating leverage to use to open foreign telecommunications markets. Therefore, he needs the powerful leverage created by automatic denial of access to the U.S. market if countries fail to open their markets to U.S. equipment and services. In addition it is highly unlikely that the President will be able politically to offer concessions affecting other sectors to gain access on telecommunications. The Congress would be unlikely to approve an agreement which includes such a transparent trade-off.

Advantage

- o Sends unequivocal message to the Japanese, the EC, and Canada that the United States is serious about achieving access to their telecommunications markets.

Disadvantages

- o Limits Presidential and USTR discretion.
- o Would require the Administration to determine publicly whether other nations are granting U.S. firms SECO in telecommunications. Given current conditions, we would probably have to identify most of our major trading partners as denying U.S. firms SECO or face serious credibility problems with Congress and our trading partners.
- o Probably would lead to counter-retaliation by at least some affected countries if we did retaliate, leading to a more restricted markets (both telecommunications and others) to the detriment of consumer welfare worldwide.
- o Elevates telecommunications to an unwarranted level of priority in light of overall U.S. trade interests.

- o Sets the Administration's trade policy off on a course of bilateral sectoral reciprocity.

Option 2: Oppose the Bill

In recommending this option, the EPC would make the fundamental philosophical decision that **the Administration does not want or need additional, sector-specific negotiating authority on telecommunications.**

Rationale

The President already has adequate negotiating authority. The Danforth bill is therefore unnecessary. The bill limits current Presidential discretion by: (1) requiring the President to engage in sector specific negotiations on telecommunications, thereby giving telecommunications priority over other sectors; (2) mandating retaliation when negotiations fail, regardless of other U.S. interests; and (3) delegating current Presidential Section 301 authority to USTR. The legislation could set a bad trade policy precedent for a series of sectoral trade laws rather than general negotiating authority.

Advantages

- o Avoids codifying a policy of sectoral reciprocity with each nation in telecommunications and the negative trade implications of such a policy.

- o Avoids limiting the President's discretion with respect to taking retaliatory action against countries.

Disadvantages

- o May well antagonize the Congress and the business community, thereby giving impetus to more troublesome legislation or expediting the pace of the Danforth bill.

- o Unless carefully handled, opposition to the bill could reduce our leverage in negotiations with Japan, and the EC and Canada may infer that the Administration is not very serious about opening those markets.

Option 3: Support Legislation That Provides Sector-Specific Negotiating Authority in Telecommunications But Does Not Limit Current Presidential Discretion

In recommending this option, the EPC would decide that **the Administration wants additional negotiating authority on telecommunications and will consider a modified version of the Danforth bill as a vehicle for getting that authority.**

Rationale

The United States has a serious trade problem in telecommunications. Ours is the only totally open telecommunications market in the world, and we are running a significant and sharply increasing deficit in this sector. Since 1982, our sectoral trade balance has decreased from a $300 million surplus to a $1.2 billion deficit. This is particularly troubling because our telecommunications products are in fact highly competitive. Other markets are restricted, and the existing international trade regime provides no avenue to achieve an equitable balance of market opportunities. A bill which increases the President's negotiating authority without limiting the President's discretion would add to the leverage of our negotiators to overcome foreign market barriers. Rather than mandating retaliation, the Congress could provide such new authority and ask the President to report on how it had been used. It appears that the Administration has a reasonable prospect for working out such a compromise with Senator Danforth and the industry.

Advantages

- Could provide significant leverage in market access negotiations.
- Is consistent with the Administration's decision to make telecommunications a high priority in negotiations with Japan.
- Avoids a backlash in Congress and in the business community.

Disadvantages

- Not clear that new authority would substantially improve the outlook for market access.
- Could be construed as putting telecommunications ahead of all other trade issues.
- May lead to demands for equal treatment by other sectors.
- Some agencies believe that choosing this option would commit the Administration to work on a bill whose premise -- bilateral, sectoral reciprocity or retaliate -- is contrary to the Administration's trade policy.

THE UNITED STATES TRADE REPRESENTATIVE
WASHINGTON
20506

May 20, 1985

MEMORANDUM

TO: ROGER PORTER

FROM: MICHAEL B. SMITH, Acting

SUBJECT: Background Paper on Telecom

As you may recall, you asked me to have a three page summary prepared of the TPSC Taskforce's Study on Telecom. Attached is the summary with updated statistics to reflect trade for the full year 1984. If you need any more information, please feel free to call. Thanks

Attachment

PRINCIPAL FINDINGS OF 1984 TPSC TELECOMMUNICATIONS TASK FORCE

-- The United States is the world's leader in the consumption, production, and sales of telecommunications equipment. Its technology is unsurpassed. But, its trade position is inferior to that of its principal trading partners.[1]

-- The United States accounts for 38% of world production in telecommunications equipment, while the EC, Japan and Canada each account for 22.5%, 11%, and 4%, respectively.[2]

-- Our 1982 surplus in telecommunications equipment of over $120 million shifted to a deficit of more than $772 million in 1983. In 1984, our deficit more than doubled to over $1.44 billion.[3] In 1983, our major trading partners -- Japan, the EC, and Canada -- had global trade surpluses in telecommunications equipment of $1.25 billion, $935 million, and $303 million, respectively.

-- The reason for the less impressive U.S. performance in the international trade of telecommunications equipment is not the level of U.S. technology relative to other suppliers or the underlying growth of the U.S. telecommunications sector. We are unsurpassed in digital switch, microwave, lightwave, and satellite technology. And, the telecommunications market in other parts of the world has generally grown as fast as the U.S. market. However, in low technology equipment such as hand-held sets, key telephone systems, and facsimilies, we are at a price disadvantage.

-- The inferior U.S. trade position is due to the following factors:

o The unilateral opening of the U.S. telecommunications market beginning with the 1968 Carterfone decision and culminating with the 1982 Consent Decree has increased competition, both domestic and foreign, for equipment sales to private customers and regional telephone companies. Those actions were taken without consideration for their international trade effects.

o Through their postal telephone and telegraph companies (PTTs) and other public entities, most foreign govern-

---

[1]For the purposes of this description, we will discuss only the markets for the United States, Japan, the EC, and Canada because these four entities account for almost 80% of worldwide apparent consumption. This aggregation is analytically sound and simplifies the presentation of massive amounts of data.
[2]Trade data include only extra-EC trade.
[3]Trade data based on 1984 ITC definition of telecommunications.

ments direct the purchase of telecommunications equipment to domestic suppliers. Purchases by these public entities are not as sensitive to price considerations as purchases by private entities because they often are influenced by non-market, sometimes political, considerations. Moreover, PTT purchases are not covered by the Government Procurement Code; hence, they can be made on a non-MFN, discriminatory basis. PTT's typically account for about 60% of a country's telecommunications market and influence the other 40% (end-user purchases of terminal equipment) through certification and approval procedures. As a result, most of the world market outside the United States remains closed to traditional market competition.

o Other countries have been more aggressive than the United States in promoting telecommunications equipment exports through their export financing banks.

o And, the high value of the dollar has helped make foreign telecommunications equipment more price competitive in the U.S. market.

o Historically, U.S.firms were not challenged by foreign firms in our market and were not export-orinted. In a 1922 Consent Decree, AT&T was forced to divest ITT and was prohibited from engaging in overseas business.

- Telecommunications companies sell to foreign customers through foreign subsidiaries, at least in part to get around market distortions created by government intervention. For example, European subsidiaries of U.S. companies generated over $3 billion in revenues in 1983, while we exported only $295 million in telecommunications equipment to Europe. U.S. companies are also well invested in Canada. And Japanese, Canadian, and European firms have considerable investments in the United States.

-- In 1984, the U.S. deficit with **Japan** was over $1.2 billion. This is nearly double our 1983 deficit of $674 million which was 70% higher than our 1982 deficit of $395 million. Japan is the largest source of imports into the U.S. market, accounting in 1983 for 45% of U.S. imports and 47% of Japan's exports of telecommunications equipment. Japan's telecommunications equipment market is and will continue to be dominated by Nippon Telegraph and Telephone Public Corporation (NTT), a private entity as of April 1 with 100% stock ownership by the Government of Japan. It controls 40% of the Japanese market for telecommunications equipment. The NTT Agreement resulted in only $330 million in U.S. sales during the first four years of the agreement, only 20-30% of which was telecommunications equipment.

-- Most **European Community** national markets are dominated by their individual PTT's who prefer to purchase equipment manufactured within their borders. European firms face significant barriers in selling in other European markets, and, because of this, vigorously pursue export markets outside the Community. This helps explain the EC's overall trade surplus in telecommunications. In 1984, the United States had a $240 million surplus in trade with the EC, a number substantially unchanged over the past five years.

-- In 1984, the United States had a trade surplus with the **Federal Republic of Germany**, **France**, **Italy**, and the **United Kingdom** of $43 million, $2 million, $23 million, and $104 million, respectively. The national PTT in each of these markets controls anywhere from 70-92% of all domestic purchases. Domestic producers, in turn, supply from 80-93% of total domestic demand for telecommunications.

-- In the **United Kingdom**, the PTT monopoly was abolished in 1981 and British Telecom, a government corporation, was formed to take charge of telecommunications services. British Telecom was privatized earlier this year. Overall, the U.K. has the most liberalized telecommunications market in Europe and appears poised to take the fastest steps toward more competition.

-- In 1984, we had a $140 million deficit with **Canada**; a sharp increase from our $11 million deficit in 1982. The Canadian industry is regulated at both a federal and province level. The provincial telephone companies procure locally. The Canadian Government also has publicly encouraged the private sector to "Buy Canadian" when purchasing telecommunications equipment. The second major non-tariff barrier in the Canadian market is vertical integration--Northern Telecom is majority-owned by Bell of Canada. Hence, Bell Canada buys 90% of its equipment from Northern Telecom. Canada also has a 17.5% tariff, the only major tariff barrier facing U.S. exporters in industrial countries.

-- **Taiwan**, **Korea**, **Hong Kong**, and **Singapore** are major exporters of customer premise equipment to the United States. While all of these countries had a surplus in telecommunications trade with the United States in 1984, their overall position is deteriorating as U.S. consumers appear to be buying fewer low-priced telephone sets. Due to their rapid rate of economic growth, these countries are large export markets for U.S. industry. No significant trade barriers exist that hinder U.S. suppliers in these markets. Often our major disadvantage in competing in these markets is the lack of export financing for U.S. suppliers compared to that offered by our principal competitor governments.